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BEFORE THE ARIZONA CORPORATION COMMISSION

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WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING ELECTRIC RESTRUCTURING ISSUES — Docket No. E-00000A-02-0051

IN THE MATTER OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR A VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606 — Docket No. E-01345A-01-0822

IN THE MATTER OF THE GENERIC PROCEEDING CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR — Docket No. E-00000A-01-0630

IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC COMPETITION RULES COMPLIANCE DATES — Docket No. E-01933A-02-0069

IN THE MATTER OF THE APPLICATION OF TUCSON ELECTRIC POWER COMPANY FOR APPROVAL OF ITS STRANDED COST RECOVERY — Docket No. E-01933A-98-0471

STAFF'S CLOSEING BRIEF

I. INTRODUCTION

In 1999, when the electric competition rules and the APS and TEP settlement agreements were finalized, all parties believed that retail competition was imminent. In order to provide a level playing field among competitors and promote lowcost power for any remaining captive customers, two key elements of the restructuring seemed to make sense: one element was transfer of generation assets as set forth in A.A.C. R14-2-1615.A ("Rule 1615.A"); the second element was the competitive procurement of power for standard offer service required by A.A.C. R14-2-1606.B ("Rule 1606.B"). In 1999, we assumed that the wholesale market would be competitive, that a sizable number of retail competitors would be eager to enter the market, and that customers would abandon their traditional utility in favor of the new competitors. Instead, the wholesale market has faltered, new competitors have failed to materialize, and incumbent utilities have not lost customers in any meaningful number.

The settlement agreements require APS and TEP to transfer their generation assets to affiliates by December 31, 2002. Today, that date is bearing down upon us, yet substantial uncertainty exists over whether the asset transfer will harm the public interest. Clearly, the circumstances that the rules were designed to address have not developed. It is equally clear that asset transfer combined with an ineffective wholesale market places the public at substantial risk. Finally, it appears that reliance on the Federal Energy Regulatory Commission ("FERC") to police the wholesale market may be ill advised. Under these circumstances, the Commission should stay asset transfer, at least until it can be assured that a workably competitive market and/or appropriate mitigation measures are in place.

Staff's recommended stay is not intended to indicate that the Commission should reverse direction and rethink its adoption of electric competition. In the long run, both wholesale and retail competition have the potential to bring advantages to Arizona consumers. Nonetheless, it is important to recognize that inadequately designed "competitive" market structures can cause more harm than good. The specter of California has haunted this proceeding, and we must all recognize that a failure of the competitive market, even if caused by inadequate market design, may affect the public's perception of the feasibility of electric competition.

It is also important to note that Staff's proposal is only to delay long enough to ensure thoughtful, deliberate responses to the complex and significant issues presented by the twin prospects of asset transfer and competitive solicitation amidst an illiquid and volatile wholesale market. For these reasons, Staff recommends that the Commission pause to be certain that the building blocks are in place that will both foster the development of a competitive market and adequately protect the public.

II. THE TRANSFER OF GENERATION ASSETS FROM A RETAIL ELECTRIC PROVIDER TO A WHOLESALE AFFILIATE IS AN IRREVOCABLE STEP THAT WILL FOREVER AFFECT THE NATURE OF THE COMMISSION'S JURISDICTION.

Before the Commission allows the asset transfer to occur, Staff wants to make it clear that there are substantial jurisdictional repercussions of such a move. Specifically, the Commission will lose its ratemaking jurisdiction over those assets. The traditional regulatory structure calls for a state commission to set utility rates based on the "cost of service." In Arizona, that means that the Commission determines retail rates by establishing the fair value of a utility's property, determining a fair rate of return on that fair value, and then establishing rates that will allow the utility to recover its reasonable costs plus a return on its investment. In the case of electric generating assets, those assets have historically been accorded rate base treatment in determining rates. By contrast, under the Federal Power Act, FERC has jurisdiction over wholesale sales of electric power in interstate commerce. Since wholesale power sales are transactions that take place over the integrated power grid, FERC has jurisdiction over virtually all wholesale power sales.

In this proceeding, APS wants to transfer its generating assets to an affiliate under the Pinnacle West Capital Corporation family of companies. If the transfer take places, subsequent acquisitions of power by APS from its affiliate would be wholesale transactions. All parties recognize that these power acquisitions would be FERC-jurisdictional. Accordingly, the Commission is without jurisdiction over any power purchase agreement that might occur after transfer of the assets.

APS' witnesses have suggested that the Commission's post-divestiture authority will be substantially identical to its pre-divestiture jurisdiction over generation assets, because of the Commission's ongoing jurisdiction over APS' retail rates. (Tr. at 462, 921). This was even referred to as "virtual regulation." (Tr. at 409). By this argument, APS infers that the generation affiliate would not dare act in a manner unacceptable to the Commission, because the Commission would have the authority to control retail rates, the ultimate source of revenue, as well as other aspects of the UDC's business conduct.

This argument should not give the Commission any comfort. The Purchase Power Agreement ("PPA") proposed by APS does not require the Commission's approval. It is only presented for review because APS chose to do so. There are a host of reasons why the Commission should decline to rely on "virtual regulation" or some other form of indirect control as a means of protecting ratepayers from the lack of actual regulatory authority in a post-divestiture setting. While harping on the California experience is not always helpful, this is one situation where the effects are particularly instructive. The California Commission presumably has the same indirect regulatory impacts over utility affiliates as this Commission has. Yet in California, at least one UDC has filed for bankruptcy despite the fact that its parent company remains solvent. The prospect of a UDC bankruptcy should be frightening for this Commission.

More importantly, Staff believes that there are a number of reasons for not "trusting" in the relationship with a UDC as a device to control the behavior of a generation affiliate. The proposed PPA does not act as an adequate substitute for traditional rate setting over the affected assets. The term is excessive, and there are no guarantees that the Commission would have authority over the proposed extensions. APS claims that those extensions would be presented to the Commission for approval, but there is no binding requirement that this occur, as the transaction would be subject to FERC jurisdiction.

In short, permitting the transfer of generation assets to an affiliate will subject power acquisition to FERC, rather than Commission, jurisdiction. There is disagreement about whether the Commission should be concerned about the impact of this jurisdictional shift on customers. Staff's concern about the loss of jurisdiction has been stated repeatedly throughout this proceeding, but bears repeating. Permitting generation assets to be transferred away from the UDC should be considered an irrevocable action that will in effect transfer jurisdiction from this Commission to FERC. The Commission should permit such action only when it has satisfied itself that the transfer is in the public interest. Without conditions designed to address market structure concerns, the transfer is <u>not</u> in the public interest.

III. TRANSFER OF ASSETS

A. Recommendations and/or Positions

1. The Commission should immediately issue an order that stays Rule 1606.B, Rule 1615.A, and the transfer provisions of Decision Nos. 61973 and 62103 until the Commission can conclude that the wholesale market is workably competitive. The ALJ should prepare such an order for the Commission's consideration as soon as possible.

2. The Commission should initiate a rulemaking proceeding to amend Rule 1615.A.

3. The utilities should not be prohibited from transferring their generation assets. However, such transfers should not be permitted unless the transfer will serve the public interest.

4. Asset transfers will promote competition, and thereby serve the public interest, as long as the wholesale market is workably competitive.

5. In order to transfer its assets, a utility should file a market power study, a market mitigation plan, and a proposed code of conduct. It may be feasible for the Commission to consider these items in a consolidated proceeding.

B. Argument

1. <u>The timing of asset transfer as currently contemplated in the APS and TEP settlement agreements is problematic; for this reason, the Commission should immediately stay the transfer provisions of both the rules and the settlement agreements</u>.

The settlement agreements require both APS and TEP to transfer their generation assets to affiliates by January 1, 2003. TEP has asked the Commission to stay that deadline until the proceedings in this case have concluded. APS, by contrast, has informed the Commission that it intends to execute its asset transfer by September 1, 2002.

Under the circumstances, the timing proposed by APS is problematic. (Rowell Direct, Ex. S-15 at 9). First, APS has admitted that implementation of the terms of the rules and the settlement agreements as they currently stand will put the public at risk. (Request of Arizona Public Service Company for a Partial Variance to A.A.C. R14-2-1606 (B) and for Approval of a Purchase Power Agreement, Docket No. E-01345A-01-0822 ("APS Variance Request"), Ex. S-1 at 1; Tr. at 75, 180-810). Staff witness Talbot concurred with this conclusion, stating that the market is too volatile to provide all of the capacity that APS would need due to an inadequate number of competitors and the existence of transmission constraints. (Tr. at 1329, 1336). Because the transfer may actually harm the public, Staff recommends that the Commission delay the transfer until the wholesale market is workably competitive or appropriate mitigation measures are in place.

Some witnesses have suggested that the Commission should simply move forward with the transfer and depend upon FERC to police the market. (Higgins Rebuttal, Ex. AECC-3 at 4-5, 11). But reliance on FERC is ill-advised. First, Congress' General Accounting Office has concluded that FERC lacks an effective regulatory approach for assuring "that today's energy markets are producing interstate wholesale . . . electricity prices that are just and reasonable." (Mundell Ex. A; Tr. at 1293). FERC apparently intends for the RTOs to act as the "frontline" in monitoring wholesale electricity markets, but it is likely to be several years before RTOs are fully operational. (Tr. at 1293). As APS witness Cicchetti suggested, we need a bridge in this transition period to span the gap between traditional monopoly regulation and the development of competition. (Tr. at 1308). However, it is unwise to rely on FERC to bridge this gap: FERC has shown that it will not respond promptly in a crisis. Accordingly, it is important for the Arizona Commission to ensure that there are appropriate market mitigation measures in place before transfer. (<u>See</u> Tr. at 1332-33).

Finally, and perhaps most important, it is not possible to achieve the competitive bidding requirements of Rule 1606.B by the end of the year. (Tr. at 1383, 1428). Even APS seems to agree with this. (Tr. at 248). Until the Commission determines how the UDC is supposed to procure power -- either through a competitive procurement process, a PPA, or some combination -- the asset transfer should not take place. Certainly, it should not take place before the end of the year. (Tr. at 1316, 1393, 1918-19). Staff recommends that the ALJ issue a proposed order immediately that stays the asset transfer at least until the conclusion of both Tracks A and B. Such a stay will enable the Commission to consider asset transfer and its associated issues as part of a concerted whole, instead of piecemeal.

2. <u>Without appropriate mitigation measures in place, consumers may not receive reliable electric service at reasonable rates</u>.

APS' variance application is premised on the assertion that the wholesale market will not produce just and reasonable rates (APS Variance Request, Ex. S-1 at 1; Tr. at 176-77). APS will argue that its proposed PPA could serve as an appropriate mitigation measure. The timing of the asset transfer, however, makes this suggestion unreasonable. The PPA presents too many problems to be resolved by the end of the year. First, although APS has alleged that its proposed PPA is entirely cost-based, (Tr. at 321), Staff's analysis shows that it is a cost-plus proposal. (Tr. at 1400). Under the terms of the PPA, APS or its affiliates would be able to establish costs, and there would be no regulatory scrutiny of those costs. (Tr. at 1400). Second, the term of the contract is inordinately long. (Tr. at 1400). Finally, the proposed PPA will not foster the development of a competitive market, because it would limit the amount of capacity open to merchant generators. (Tr. at 909-10, 1401).

APS may argue that it has unfairly been denied the chance to present its PPA, as the variance proceeding has been stayed. However, APS' timing put the Commission in an untenable position: APS informed the Commission shortly before the variance proceeding was scheduled to begin that it would deliver its thirty-day notice on August 1, 2002. This gave the Commission no choice but to stay the variance proceeding in favor of the current one.

3. <u>Asset transfer, as set forth in the Commission's electric competition rules, was designed to address a completely different set of circumstances, which have not materialized; for this reason, the requirement that utilities transfer their assets should be stayed</u>.

The Commission considered and adopted A.A.C. R14-2-1615, the asset transfer rule, as part of a plan to introduce retail competition. This rule was originally enacted as a means to level the playing field between the incumbent utilities and new competitors. At the time the rules and the settlement agreements were approved, the Commission and the industry anticipated that competitors would enter the retail market and that consumers would have a choice among electric providers. (Rowell Direct, Ex. S-15 at 5). Theoretically, the presence of competitors would discipline the market, bringing increased efficiencies to the industry and lowering costs to the end user. (Rowell Direct, Ex. S-15 at 5). But without the entrance of retail competitors, these benefits are lost. <u>Id</u>. Accordingly, the Commission finds itself in the situation of applying a plan, i.e., that created by the electric competition rules and the settlement agreements, to circumstances that the plan was never intended to address. <u>See</u> Tr. at 1388-89. In these circumstances, it is no longer necessary to <u>require</u> utilities to transfer their assets; accordingly, Staff recommends that the Commission issue an order staying Rule 1615.A and directing Staff to initiate a rulemaking to amend it.

4. <u>How should the Commission view asset transfer in the long run</u>?

It seems clear that asset transfer, at least in the short run, is not in the public interest. The wholesale market is simply not likely to produce just and reasonable rates. (Tr. at 929, 972, 1329). Further, APS' PPA, the only specific mitigation measure so far proposed, presents serious problems. In these circumstances, going forward with asset transfer by the close of 2002, as currently proposed in the settlement agreements, would be unwise. Certainly, APS and TEP should not be permitted to transfer their assets anytime this year.

Naturally, one next turns to the question of when, if ever, the utilities should be permitted to divest. It would be easy to recommend that the Commission stay the electric competition rules entirely and adopt a "wait and see" attitude, continuing under the traditional regulatory model until the outcome of the debate over competition is further along. See Tr. at 385. But Staff believes that the Commission has indicated a preference for competition. The Commission has had opportunities to indicate otherwise,[1] and has so far declined to take them. Accordingly, the task before us is to determine what the Commission can do to encourage competition while at the same time protecting customers. (Rowell Direct, Ex. S-15 at 5).

For the immediate future, Staff believes that this balance should tip in favor of consumers. For this reason, Staff recommends that asset transfer be delayed until the Commission is assured that a workably competitive market and/or adequate mitigation measures are in place. Staff believes that the following events must occur before the Commission can decide whether any particular utility should be allowed to divest:

a. First, the utility should indicate whether it still wants to divest.

Current Rule 1615 as well as the settlement agreements require both APS and TEP to divest. Staff has recommended that this requirement be stayed and eventually amended. Utilities should not prohibited from divesting, as long as the divestiture will serve the public interest. Staff recommends that the utilities inform the Commission of whether they intend to pursue divestiture within thirty days of the conclusion of Track B.

b. Second, if a utility chooses to pursue divestiture, it should file market power studies.

These market power studies should be accompanied by any market mitigation plans that may be appropriate to support the divestiture request. They should also address the elements suggested by Staff witnesses Rowell, Smith, and Schlissel. (Rowell Direct, Ex. S-15 at 10-11; Schlissel Direct, Ex. S-8 at 5; Smith Direct, Ex. S-13 at 26).

c. Third, if a utility chooses to pursue divestiture, it should file a proposed code of conduct.

[1] APS' Motion for Determination of Threshold Issue

The proposed code of conduct should address the issues raised in Staff witness Keene's testimony. (Keene Direct, Ex. S-11 at 8). Staff believes that it may be feasible to consolidate a utility's application to divest, its market power studies and accompanying mitigation plans, and code of conduct in one proceeding.

d. Fourth, the Commission should finish the Track B proceedings.

Staff notes that some Track B issues may be affected by the utilities' decisions on divestiture. For example, if a utility were to choose not to divest, the provisions of Rule 1606.B would probably not be achievable. (Rowell Direct, Ex. S-15 at 6). For this reason, it would be helpful for the utilities to indicate their intentions regarding divestiture as early as possible.

e. Finally, Staff believes that utilities should not be permitted to divest RMR generation.

RMR generation presents special issues, both in terms of reliability and market power. See Tr. at 77. Although APS argues that the Arizona Independent Systems Administrator ("AISA") protocols and eventually the WestConnect protocols will address these issues, Staff believes that the future of both of these organizations is too uncertain to provide reliable solutions. Until an RTO becomes operational and demonstrates an ability to address these issues, Staff recommends that the Commission retain jurisdiction over RMR units.

5. Staff's recommendations on divestiture may have implications for future rate setting.

If a utility chooses to retain its assets, the Commission should apply traditional cost of service principles when setting rates. (Tr. at 920, 1295). If, on the other hand, a utility chooses to divest and then enters a buy-back agreement with an affiliate, it should do so only if it can reasonably expect to get at least as good a deal from the affiliate as it could get in the marketplace. (Tr. at 1296). If and when a utility obtains power to serve a portion of its load in the competitive market, the Commission should generally review those purchases in reference to the relevant market, i.e., without a cost-based benchmark. (Tr. at 1295). This general rule, however, should not preclude cost-based comparisons in appropriate situations.

Although Staff is not suggesting an inflexible "lower of cost or market" standard, there may be circumstances when a cost-based benchmark is appropriate. For example, both APS and Staff agree that the wholesale market is not currently sufficiently competitive to result in just and reasonable rates. (APS Variance Request, Ex. S-1 at 2-3; Tr. at 175, 1294). APS agrees that the existing rules and its settlement agreement, without modification or variance, will place customers at risk. Nonetheless, APS has publicly stated that, if the Commission denies its request for variance and refuses to approve its proposed PPA, it intends to go forward with the asset transfer. (April 25, 2002 Open Meeting Tr., Ex. S-2 at 69). In light of these admissions, Staff can only conclude that APS is more focused upon its business interests than upon the ratepayers' interests. As APS witness Davis stated when commenting on Staff's recommendation to incorporate a cost-based benchmark, "an individual running a business would not move those assets"... (Tr. at 74). When faced with a standard that would force the company to bear the risk of the asset transfer, Mr. Davis concludes that it would be imprudent to proceed. But if it is imprudent to force the company's shareholders to bear that risk, it is equally imprudent to force ratepayers to bear it. Under such circumstances, the asset transfer would certainly appear to be imprudent, and APS should not expect such decisions to be shielded from prudence review.

IV. THE CONDITION OF THE WHOLESALE MARKET

A. Recommendations and/or Positions

1. The wholesale market is not currently workably competitive; therefore, reliance on that market will not result in just and reasonable rates.

2. APS has market power in its Phoenix Valley and Yuma load pockets.

3. TEP has market power in its Tucson load pocket.

4. The Commission should require APS and TEP to produce market power studies accompanied by market mitigation plans before allowing them to divest.

5. The wholesale market applicable to Arizona is poorly structured and susceptible to possible malfunction and manipulation.

B. Argument

1. <u>At present, the existing wholesale power supply margin is thin, and Arizona transmission constraints limit delivery from some new Arizona power plants</u>.

On February 16, 2001, APS and TEP both presented evidence at a Commission energy workshop that the existing wholesale market is thin. (Smith Direct, Ex. S-13 at 4-5). The evidence at the workshop established that both APS and TEP were taking measures to develop adequate generation resources for 2001 and 2002 due to inadequacies in the wholesale market. Id. Significant transmission constraints around Arizona's major load centers contribute to the thinness of the wholesale market. Id.at 6-7. In addition, the existing natural gas infrastructure serving Arizona is inadequate. Id. at 5-6.

Staff believes that an adequate supply margin may be emerging in Arizona. Id. at 14. However, the degree to which the supply margin will be competitive will depend upon the resolution of transmission constraints and gas pipeline capacity. Id. Once local transmission constraints are resolved, Staff believes that the number of new generators constructing or planning to construct in Arizona will result in a sufficient competitive supply margin. However, this may not be fully realized until the latter half of this decade. Id.

2. If asset transfer proceeds as planned, both APS' and TEP's affiliates will have market power within substantial portions of their service territories.

a. As a result of asset transfer, APS and its affiliates will be able to exercise market power, most significantly within the Phoenix Valley and Yuma.

Staff witness Schlissel prepared a preliminary screening analysis to examine the potential for APS and its affiliates to exercise market power if the asset transfer is allowed to go forward. Mr. Schlissel used the Supply Margin Assessment ("SMA") or "pivotal supplier" test that FERC has used pending completion of a generic rulemaking proceeding. Id. at 4. Applying the SMA screen, Mr. Schlissel determined that APS' generation capacity would be needed to meet the peak demands of its customers in the Phoenix Valley load pocket. (Schlissel Direct, Ex. S-8 at 6; Schlissel Rebuttal, Ex. S-9 at 5). APS would similarly have the ability to exercise market power in its Yuma and Douglas load pockets. (Schlissel Direct, Ex. S-8 at 7).

The potential for market power is enhanced by the fact that, for the foreseeable future at least, some APS or affiliate-owned generating facilities located outside the Phoenix Valley will continue to be needed to serve both peak and non-peak customer demands within that load pocket. Id. This is due to the limited amount of merchant capacity that will be capable of being imported into the Phoenix Valley. Id. APS' control over the existing transmission system also creates vertical market power concerns about APS' possible use of that control to advantage its own affiliates while disadvantaging competitors. Id.

APS witness Hieronymus claims that APS would not be able to exercise market power in its own service territory or in the larger western markets. However, Dr. Hieronymous' application of the SMA test to the APS control area does not present a meaningful analysis because it fails to reflect transmission system constraints. (Schlissel Rebuttal, Ex. S-9 at 1). It is also at odds with statements he made at the hearing ,in which he conceded that APS' affiliate may have market power for some period of time after the transfer. (Tr. at 927, 940, 964, 972-75, 977-78). Furthermore, his conclusions about the larger western markets are irrelevant, because APS clearly has market power in the Phoenix Valley and Yuma load pockets, which together represent more than two-thirds of APS' retail load. Id. at 2-3.

APS has acknowledged that its unregulated affiliate could exercise market power in pricing output from its in-pocket generation units. (Schlissel Direct, Ex. S-8 at 8). APS witness Hieronymus, in a previous case, testified that:

> [load pockets create market power concerns] because only generation within the load pocket can meet the load that exceeds the import limit. If there is only one, or very few owners of generation in the pocket, and the prices that they charge are not regulated, the owner(s) may be able to charge excessive prices.

Id.

In this case, APS has argued that the AISA protocols ensure that the output from must-run units will be priced on a cost basis during must-run periods. APS also argues that the WestConnect protocols, set forth in WestConnect's filing at FERC, contain similar protections. But the future of these entities is uncertain. The AISA is currently the subject of a pending docket before this Commission. Some commissioners have expressed concerns about the efficacy of the AISA, and the Commission's Staff has recommended that it be the subject of further study. Although the AISA still exists as an organization, it may be risky for the Commission to rely on it to solve these kinds of market power problems. Although WestConnect may well contain protocols that address these subjects, FERC has yet to approve the WestConnect filing. Thus, it is speculative to rely on any of its provisions.

b. TEP's affiliate would have market power in the Tucson load pocket.

Asset transfer for TEP would create similar market power concerns. All of TEP's retail loads are located within its Tucson load pocket. Id. at 13. Consequently, applying the SMA screen shows that TEP would have the ability to exercise market power within the Tucson load pocket because its generation would be needed to meet peak demand. Id.

Because of these market power concerns, the Commission should require APS and TEP to present detailed analyses of the potential for the exercise of market power before the Commission allows the asset transfers to proceed. Id. at 2. A proper analysis of the market power implications of the proposed transfer would require an electric system simulation model to examine the hourly behavior of the market under a wide variety of physical conditions, contractual situations, and bidding behaviors. Such an analysis should reflect the transmission system constraints discussed in Docket No. E-01345-01-0822 by Staff witness Smith and the APS witnesses. It would also examine the potential for the exercise of market power during both peak and non-peak hours in both peak and non-peak seasons. Id. at 12. Finally, these studies should be subject to Commission review in some sort of public proceeding in which interested parties would have a chance to participate and to submit comments. (Tr. at 1402).

3. Arizona's wholesale market lacks structure and may be subject to malfunctions and manipulations.

APS contends that the current problems are not related to market power, but are instead the result of the dysfunctional nature of the wholesale market. As Mr. Davis stated,

> I do not believe the rules as they currently exist vest in APS any market power, and I do not believe the existence of market power . . . was the predicate for our October filing. The purpose of that filing was to reflect the fact that the wholesale market had turned out to be far more volatile and far more unpredictable than perhaps had previously been anticipated.

(Tr. at 17). Even if the Commission agrees with APS, there is still cause for concern. Market power and market dysfunction cause the same results for consumers: prices that are higher--and at times much higher--than prices that would prevail if the market were truly competitive.

Market manipulation of the kind that occurred in California is only possible in a market that is poorly structured and inadequately regulated. Although Arizona fortunately did not copy California's blueprint for competition, we have had our share of disappointments. The first is the lack of any specific organization to oversee the market. At the time that the electric competition rules were adopted, the Commission expected DesertStar, the forerunner of WestConnect, to develop within a reasonable time. Yet now, almost three years after the adoption of the electric competition rules, we are still waiting for the establishment of an RTO. (Tr. at 1141). Currently, there is no specific market structure in place and no RTO with the authority to oversee that market and the opportunities for manipulating the system. (Rowell Direct, Ex. S-15 at 9; Tr. at 1312, 1355).

V. CODE OF CONDUCT

A. Recommendations and/or Positions

1. Any investor-owned utility that wants to purchase power from an affiliate within twelve months of a Commission decision in this docket must file a code of conduct for Commission approval within ninety days of a Commission decision in this docket.

2. Any investor-owned utility that has already purchased power from an affiliate must file a code of conduct for Commission approval within ninety days of a Commission decision in this docket.

3. Any investor-owned utility that has not made a filing in response to nos. 1 or 2 above but in the future plans to purchase power from an affiliate must obtain Commission approval of a code of conduct before executing any affiliate transactions.

4. Prior to a transfer of generation assets to an affiliate, an investor-owned utility must file a code of conduct for Commission approval unless such code of conduct has already been filed in response to recommendations nos. 1, 2, or 3 above.

B. In Regard to Affiliate Relationships, the Commission Should Adopt a Code of Conduct to Fill the Gaps among Existing Codes of Conduct.

The code of conduct should cover an investor-owned electric utility regulated by the Commission and all affiliates from which the utility may purchase power or which are in energy-related fields. (Keene Direct, Ex. S-11 at 8). The code of conduct should address, at a minimum, arm's-length transactions; access to confidential information; cross-subsidization; preferential treatment to affiliates; joint employment and employee transfer issues; sharing of office space, equipment, and services; proprietary customer information; financing arrangements with affiliates; and conflicts of interest. Id. In particular, Staff recommends that transactions between affiliates be at arm's length, with the same representative not appearing on both sides of a transaction. Id.

Staff believes that the negotiations surrounding APS' proposed PPA provide an example of some of the behavior that concerns Staff. APS witness Davis testified that he acted as the "arbiter" of those negotiations. (Tr. at 138). Mr. Davis further testified that negotiations between APS and its affiliates would always need such an arbiter and could never be truly at arm's length. See Tr. at 264-65. Considering that Rule 1606.B requires APS to procure power in the competitive market through arm's length transactions, Staff is concerned that APS may be unable to develop appropriate procedures to accomplish this without Commission oversight. For these reasons, Staff recommends that the Commission require electric utilities to develop codes of conduct that address the issues set forth in Staff witness Keene's testimony.

VI. ELECTRIC COMPETITION ADVISORY GROUP

Through its ordinary duties, Commission Staff communicates with industry participants and monitors the industry in an informal manner. However, a more formal approach toward facilitating communication and information sharing has not been established. Staff therefore recommends that the Commission form an Electric Competition Advisory Group for purposes of facilitating communication and the sharing of information among Staff, stakeholders, and market participants.

VII. TRANSMISSION ISSUES

A. Recommendations and/or Positions

1. The Commission should encourage an industry-wide collaborative planning process to resolve transmission constraints. (Smith Direct, Ex. S-13 at 25).

2. Staff recommends that the Commission initiate an appropriate proceeding to consider the adoption of the following standards:

    a. There should be sufficient transmission import capability to reliably serve all loads in a utility's service area without limiting consumer access or benefit to more economical or less polluting generation located external to the service area. Id.

    b. A power plant must have sufficient interconnected transmission capacity to reliably deliver its full output without use of remedial action schemes for single contingency (N-1) outages or displacing a priori generation interconnected at the same switchyard or on the same transmission lines. Id.

3. The Commission should order jurisdictional utilities to resolve RMR generation concerns. Specifically, the utilities should be ordered to:

   a. perform a study within thirty days of a Commission decision in Track A analyzing the merits of existing dependence on RMR generation instead of building transmission to resolve local transmission import reliability constraints;

   b. perform a study analyzing the merits of any future contemplated utilization of RMR to defer transmission projects; and

   c. file such RMR study reports with the Commission for review within thirty days of their completion and prior to implementing any new RMR generation strategies. Id at 26.

4. Staff recommends that the Commission consider appropriate avenues to establish the following criteria:

   a. Future power plant applications for CECs should be denied for sufficiency purposes if they have not fulfilled the statutory technical study requirements demonstrating the impact of the project on the existing Arizona transmission system; and

   b. Power plants that fail to demonstrate the ability to reliably deliver to a market without displacing a priori generation interconnected at the same location or utilizing the same interconnected transmission system should not be granted a CEC. Id. at 25-26.

B. Both transmission providers and merchant power plants should share the burden and obligation to resolve Arizona's transmission constraints.

Generation and transmission in Arizona are presently inadequate to ensure reliable electric service to the consumers of Arizona once we transition to a competitive market. Id. at 4. Within the next few years, however, Staff believes that the number of new power plants and transmission projects will establish a marginally reliable electric system with a supply margin of sufficient capacity to facilitate a competitive wholesale market. Id. at 4. Nonetheless, more transmission will be needed to facilitate the restructuring of the electric industry to reliably serve Arizona customers. Id. at 23. Staff believes that the Commission should encourage accelerated development of transmission solutions in order to facilitate electric restructuring and to ensure that Arizona customers receive reliable service at reasonable rates. Id.

All parties seem to agree that transmission planning will be different in a competitive market. (Smith Direct, Ex. S-13 at 9-10; Tr. at 1140). Under traditional regulation, the monopoly utility could oversee virtually all aspects of planning, such as the location of power plants and the timing of new construction. But in a restructured market, merchant generators choose the location of plants, and more transmission flexibility is needed in order to allow the system to accommodate the additional participants. Id. This means that, in order to ensure reliable service in a competitive market, Arizona will need more transmission than it would have needed under traditional regulation. (Smith Direct, Ex. S-13 at 21; Tr. at 1356-57). Considerable dispute attends the question as to who should pay for these transmission expansions. (Tr. at 1357).

Contrary to APS' characterizations, Staff is not suggesting that the UDC is responsible for building out its transmission system to ensure that all merchant plants are capable of delivering their entire output throughout the UDC's entire system. (Smith Direct, Ex. S-13 at 25-27) On the other hand, it is somewhat unreasonable for UDCs to continue to plan their systems based on traditional monopoly principles, as APS appears to have done. (Tr. at 6-7, 21). Certainly, it would be reassuring to hear that APS' transmission planners are at least aware of the substance of the Commission's electric competition rules--an assurance that APS witness Deise could not provide. (Tr. at 1130-31).

Staff does not have a magic answer for these issues. The inquiry is complicated by concerns about who will pay for extending the transmission system and by jurisdictional complications that make it difficult for the Commission to require all relevant parties to participate in a collaborative process. Staff believes, however, that its recommendations provide a starting point for the Commission to gather the necessary data and to initiate proceedings, whether rulemakings or other, that will allow it to address these issues.

C. Profit vs. Not-for-Profit RTOs

FERC has jurisdiction over both profit and not-for-profit RTOs. Staff believes that the structure of an RTO will not affect the nature of FERC's jurisdiction over it.

VIII. AFFECTED RULES AND/OR DECISIONS

Staff believes that the following rules and decisions would be implicated by the adoption of

Staff's proposals: Rule 1606.B, Rule 1611.A, Rule 1615.A, Decision No. 61973 (APS settlement), and Decision No. 62103 (TEP settlement).

IX. CONTRACT ISSUES

APS argues that the Commission is a party to APS' settlement agreement and therefore has no option but to allow the asset transfer to proceed. The Commission, however, should not allow itself to be influenced by APS' attempts to limit its authority. The Commission is not contractually bound by the settlement agreement. Assuming solely for the sake of discussion that such a contract exists, it is unenforceable.

A. The Commission Is Not Contractually Bound by the Settlement Agreement.

Settlement has a different meaning in an administrative context than it does in civil actions. See Pennsylvania Gas & Water Co. v. Federal Power Comm'n, 463 F.2d 1242, 1246 (D.C. Cir. 1972). In agency proceedings, settlements are frequently proposed by a party or parties. If the regulatory agency concludes that the proposed settlement is reasonable, the terms of the settlement form the substance of an order binding on all the parties, even those that are not signatories to the settlement. Id. at 1246. The approved agreement looses its private contractual character and assumes the nature of an agency order enacted in the public interest. See Cajun Elec. Power Coop., Inc. v. F.E.R.C., 924 F.2d 1132, 1135 (D.C. Cir. 1991). Accordingly, the Commission has the authority to approve a settlement agreement without becoming a party to it.

APS may argue that the original settlement agreement clearly sought to make the Commission a party to the agreement. But because of the amendments that the Commission made to the agreement, it is unlikely that the Commission is contractually bound. As rewritten by the Commission, Section 2.8 has the potential effect of eliminating any restriction on the Commission's ability to change APS' rates. This language has the potential to provide the Commission with "an unfettered right to decide later the nature or extent of [its] performance" and makes its promise "merely illusory." Allen D. Shadron, Inc. v. Cole, 101 Ariz. 122, 416 P.2d 555 (1966). Such a promise is too indefinite for legal enforcement. Id. at 123, 416 P.2d at 556; see also Pyeatte v. Pyeatte, 135 Ariz. 346, 351, 661 P.2d 196, 201 (App. 1982) (noting that, when essential terms and requirements of an agreement are not sufficiently definite, the obligations of the parties cannot be determined); Ellis v. Dodge Bros., 237

F. 860, 867 (N.D.Ga. 1916) rev'd on other grounds ("[T]o agree to do something and to reserve the right to cancel the agreement at will is no agreement at all . . . .").

In addition to the changes made to Section 2.8, the Commission required a variety of other changes throughout the agreement.[2] One might argue that the settlement was intended to convey an offer, and that the Commission's order approving the settlement constituted acceptance. But an acceptance varying the terms of the offer rejects the original offer. United California Bank v. Prudential Ins. Co. of America, 140 Ariz. 238, 272, 681 P.2d 390, 424 (App. 1983). And there is a presumption against the creation of a contract in a regulatory order. U S WEST Communications, Inc. v. Arizona Corp. Commission, 197 Ariz. 16, 223 P.3d, 936, 942. (App. 1999). The Commission, by its approval of the settlement agreement, did not become a party to it.

B. Because the Alleged Contract was Based on the Existence of a Workably Competitive Wholesale Market, and Because a Workably Competitive Wholesale Market Does not Exist, the Purpose of the Alleged Contract has Been Frustrated, Thereby Excusing Performance.

The doctrine of frustration of purpose traces its roots to Krell v. Henry, [1903] 2 K.B. 740. There, the owner of a London apartment advertised it for rent as a location from which to observe the King's coronation parade. Responding to the advertisement, the renter paid a deposit and agreed to rent the apartment for two days. When the coronation parade was postponed, the renter refused to pay the balance of the rent. The court held that the contract to rent the apartment was premised on an implied condition—the occurrence of the King's coronation parade. Id. at 754. Accordingly, when the parade was canceled, the renter's duty to perform was discharged by the frustration of his purpose in entering the contract. Id.

The doctrine of frustration of purpose is established in Arizona and has four requirements. 7200 Scottsdale Road General Partner v. Kuhn Farm, 184 Ariz. 341, 346, 909 P. 2d 408, 413 (App. 1995) (citing Garner v. Ellingson, 18 Ariz. App. 181, 501 P. 2d 22 (1972); Matheny v. Gila County, 147 Ariz. 359, 360, 710 P.2d 469, 471 (1985)); Mobile Home Estates, Inc. v. Levitt Mobile Home Systems, Inc., 118 Ariz. 219, 222, 575 P.2d 1245, 1248 (1978). First, "the purpose that is frustrated

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[2] In addition to the changes made to Section 2.8, the Commission required changes to Sections 2.3, 2.6(3), 4.1, 4.3, 7.1, and 7.7.

must have been a principal purpose of that party" and must have been to the understanding of both parties. Restatement (Second) of Contracts ("Restatement") § 265 cmt. a (1981). Second, "the frustration must be substantial...; [it] must be so severe that it is not to be regarded as within the risks assumed ... under the contract." Id. Third, "the non-occurrence of the frustrating event must have been a basic assumption" of the parties to the agreement. Id. Finally, relief will not be granted if the risk of the frustrating occurrence, or the loss caused thereby, should properly be placed on the party seeking relief. See Restatement § 265 cmt. b.

Relying on Krell, the Kuhn court stated that to show frustration it must be shown "that the frustrated purpose was 'the subject of the contract ... and was so to the knowledge of both parties.'" Kuhn, 184 Ariz. at 348 (quoting Krell, [1903] 2 K.B. at 754 (emphasis added in Kuhn). In Krell, the viewing of the coronation parade was as much the purpose of the owner's rental of the apartment as it was the renter's purpose in renting it. [1903] 2 K.B. at 751. The overarching purpose of the settlement agreement was to fulfill the public policy statement contained in both the electric competition rules and A.R.S. §40-202.B: establishing a competitive market for the sale of electric generation. Put another way, the purpose of the alleged contract was to force APS to buy power in the competitive wholesale market.

Here, the failure of the wholesale market is the frustrating event. APS has stated that it cannot acquire one hundred percent of its standard offer power through arm's length transactions in the competitive market, nor can it acquire fifty percent through competitive bid. This inability totally or nearly totally destroys any value the Commission would receive form this alleged contract. See Kuhn, 184 Ariz. at 349 (quoting Lloyd, 153 P.2d at 50). Accordingly, this alleged contract is unenforceable.

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X. CONCLUSION

For the foregoing reasons, Staff recommends that the Commission adopt Staff's postions and recommendations as set forth herein.

RESPECTFULLY SUBMITTED this 10th day of July, 2002.

Janet F. Wagner

Christopher C. Kempley, Chief Counsel
Janet F. Wagner, Attorney
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007
(602) 542-3402

Original and ten copies of the foregoing filed this 10th day of July, 2002, with:

Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

Copy of the foregoing mailed this 10th day of July, 2002, to all parties of record.

Angela L. Bennett

Angela L. Bennett